Redstone Advisors

Municipal Market Review

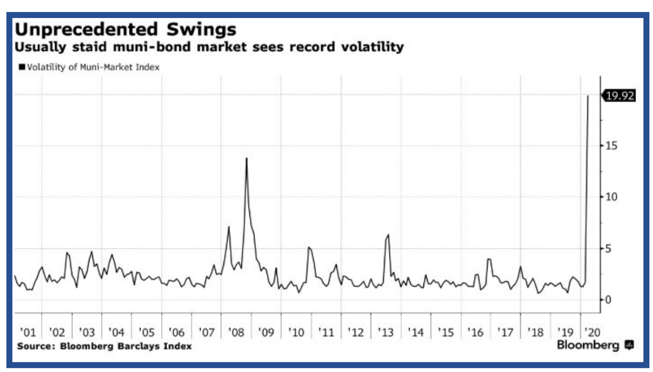
First Quarter 2020

"Municipal bonds as an asset class have been backstopped by both Congress and the Federal Reserve and with all of that are still very cheap historically to US Treasuries."
Michael Pietronico, MT Asset Management

All of us at Redstone Advisors wish our readers well in these historic, challenging times. We hope your family and loved ones are safe and in good spirits. We would also like to extend our deepest gratitude to all the doctors, nurses, paramedics, medical personnel and essential service employees working tirelessly on the frontlines in this battle. Their dedication and sacrifice make them true heroes.

This past quarter, the financial markets have been tremendously impacted by the spread of the Covid-19 pandemic. And while the municipal bond market may be exempt from taxes, it has not been exempt from the volatility storm unleashed by this coronavirus. The calm before the storm was in early March, when yields in the municipal market touched an all-time low, and prices reached an all-time high. "Beware the ides of March" would be a prescient warning, as it was mid-March when municipal bond yields first started to surge amidst a tsunami of client withdrawals from mutual funds as panicked investors fled to the safe haven of cash amidst the uncertainty surrounding the economic and financial fallout from the coronavirus. Investors pulled a record $12.2 billion out of municipal bond mutual funds in the week ended March 18th. This record outflow was nearly three times the previous record of $4.5 billion. The fierce sell-off through mid-March was the steepest in at least four decades. The unprecedented volatility that defined the month of March can be seen in Figure 1.

Fig 1



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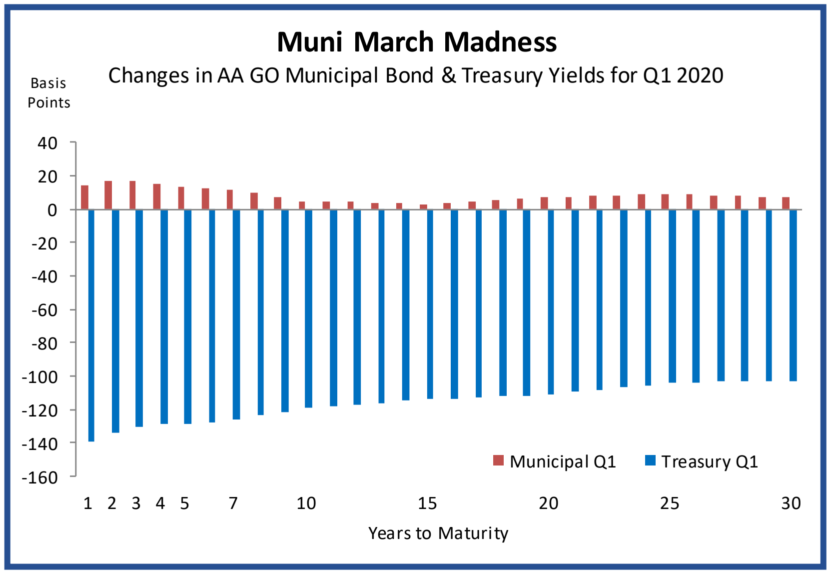
In a burgeoning financial crisis, when liquidity is rapidly disappearing, mutual fund managers are forced to sell into very illiquid markets in order to meet redemptions. Very often, that means they must sell their best bonds as they are the only ones for which a bid is available. We saw this in spades in the middle of March, as the baby was seemingly being thrown out with the bath water. This significant dislocation in the muni market created a narrow window of tremendous opportunities for those with cash on hand, to pick up high-quality municipal bonds at distressed, fire sale prices. It was not a time to sell bonds. Nuveen's John Miller put it this way, *"This is an asset class that is geared more for the long-term. This is a short-term overreaction that creates value for the long-term."*

Certain sectors of the municipal market will surely be adversely affected by the coronavirus as the economy slackens. For example, bonds for airports, public transit systems, toll roads, shipping terminals, stadiums, hospitals, nursing homes, student housing facilities, hotels and convention centers are seeing negative price pressure. Shelter-in-place measures and social distancing guidelines meant to minimize the spread of the coronavirus have created a bifurcated municipal market of sorts, where investors are trying to separate the credits that will experience negative revenue impacts from those that are positioned to weather the financial effects. These concerns have created an increased demand for essential service bonds for utilities like water, sewer & electricity, where stay-at-home mandates don't affect revenue flows. There is also demand for general obligation (GO) bonds backed by a state/city/county's full faith and credit, generally including its authority to levy taxes, most often property taxes. This broad taxing power provides municipalities a strong backstop in a crisis or recession. *"We're seeing something that this country hasn't seen in a long time, which is huge portions of the country shutting down, huge portions of the economy shutting down, for at least a little while, which is going to affect munis differently in different places,"* said the CEO of Thornburg Investment Management.

Municipal bond yields typically take their cues from benchmark Treasury yields, but that relationship was significantly upended in March. Munis across the yield curve yielded roughly two to four times as much as Treasuries at quarter-end, the biggest spread since at least 2001, according to Bloomberg data. Treasury yields declined in March, due to two emergency Federal Reserve rate cuts of 50 bps and 100 bps, as well as

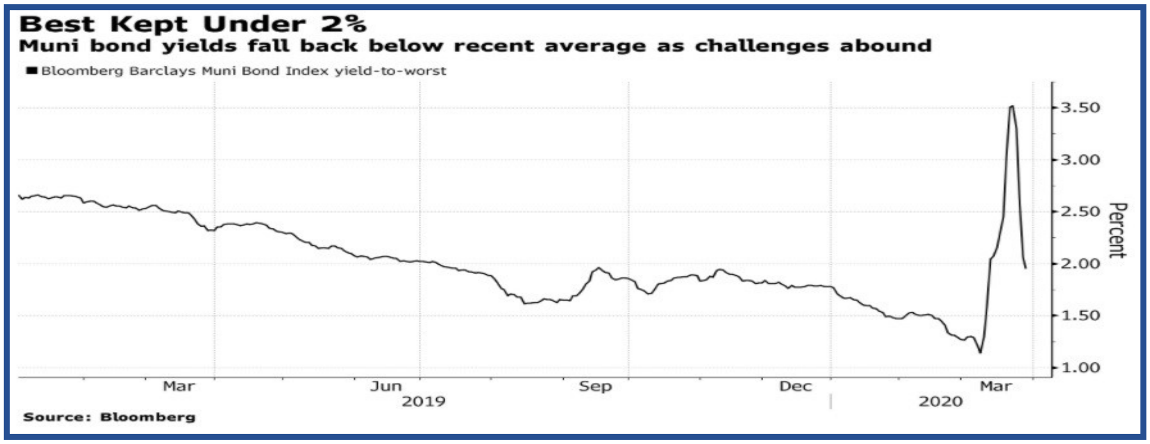
Fig 2



a flight to safety amid the pandemic fear. *"Municipals look great on a pretax basis, they look amazing on a post-tax basis. Municipals broadly have never had this attractive a valuation compared to Treasuries,"* noted Tom Graff of Brown Advisory. Municipal relative value ratios finished the quarter sharply higher. After a rollercoaster ride of a month in March, where unusually large basis point (bp) swings occurred over a roughly two- week period, muni yields ended the quarter relatively unchanged from December 31. The reshaping of the yield curves is reflected in Figure 2, which graphs the changes in muni and Treasury yields for the first quarter.

On March 25, Congress agreed to a $2 trillion stimulus/recovery package to help alleviate the impact of the economic slowdown due to the coronavirus. The Coronavirus Aid, Relief, and Economic Security (CARES) Act authorized the Fed to purchase munis as needed through a $454 billion Economic Stabilization Fund. Municipal bonds rallied hard on the news, as yields fell by more than 60 basis points; this was the biggest one-day rally since 1993. The rally continued the next day, March 26, resulting in the biggest two-day rally in decades, driving yields down more than 100 basis points. By March 30, the Bloomberg Barclays Municipal Bond Index yield-to-worst fell back under 2%, its average dating back to the beginning of 2019. This is illustrated in Figure 3. *"This will inspire confidence that a bridge is being built to help get us to the other side as we continue to deal with challenges resulting from this unprecedented moment,"* said James Iselin of Neuberger Berman Group. Many others in the market saw it as a welcome move amid the heightened uncertainty about how badly local municipalities, hospitals and public transit systems will be hurt by an economy that has essentially ground to a halt in a matter of weeks. *"We think the municipal*

Fig 3



market-specific provisions should help correct the market dislocation," said Tom Kozlik of Hilltop Securities. Municipal bonds rallied strongly during the final week of March. That week was the best for municipal debt since 1982, according to Bloomberg Barclays indexes.

The CARES Act paves the way for the Fed to act in a manner going beyond anything it did during the 2008 financial crisis, in a sign of the extraordinary challenges facing the nation. *"The Fed has effectively shifted from lender of last resort for banks to a commercial banker of last resort for the broader economy,"* said JPMorgan Chase's chief US economist. Fed Chair Jerome Powell, in a rare nationally-televised interview on the Today show said that, *"Effectively one dollar of loss absorption of backstop from Treasury is enough to support $10 worth of loans. When it comes to this lending we're not going to run out of ammunition."* Mr. Powell added that the Fed was trying to create a bridge over what many forecast to be a substantial contraction of GDP in the second quarter, to a resumption of growth sometime in the second half of the year. *"It's very hard to say precisely when that will be,"* he said. *"It will really depend on the spread of the virus. The virus is going to dictate the timetable here."* The economist Milton Friedman famously proposed the idea of a helicopter drop of money into an economy fighting a severe recession. *"This is helicopter credit"* is how one chief economist described the Fed's actions. Analysts note that it's in the best interest of the Fed and the national economy to have the muni bond sector functioning effectively, particularly when the current downturn is driven by a coronavirus that drags in states and localities as providers of health care and public services.

On April 9, the Federal Reserve released details of its new Municipal Liquidity Facility, which allows it to purchase up to $500 billion of short-term municipal debt directly from US states, Washington DC, US counties with at least two million residents, and US cities with at least one million residents. Only one issuer per state, city or county is eligible. State-level issuers can use the proceeds to support their counties and cities, if they so choose. Securities eligible under the program are tax, revenue and bond anticipation notes, which governments typically sell when they're facing temporary shortfalls in revenue or waiting to sell long-term debt. These eligible notes must have a maturity of two years or less. Purchases will stop on September 30, 2020 unless the facility is extended. In a statement, Mr. Powell said, *"Our country's highest priority must be to address this public health crisis, providing care for the ill and limiting the further spread of the virus. The Fed's role is to provide as much relief and stability as we can during this period of constrained economic activity, and our actions today will help ensure that the eventual recovery is as vigorous as possible."* The Fed also said it will continue to closely monitor conditions in the primary and secondary markets for municipal debt and will decide whether additional measures are needed to support the flow of credit and liquidity.

Redstone Advisors, with our 25+ years of experience in the municipal bond market, believe we are uniquely qualified to pursue our two primary objectives of wealth preservation and building par value by actively managing portfolios for our clients. We conduct independent credit research, adjust for duration and constantly monitor the market for risks and opportunities. High quality municipal bonds continue to be a safe and attractive investment sector in this time of great societal and financial uncertainty.

Fig 4

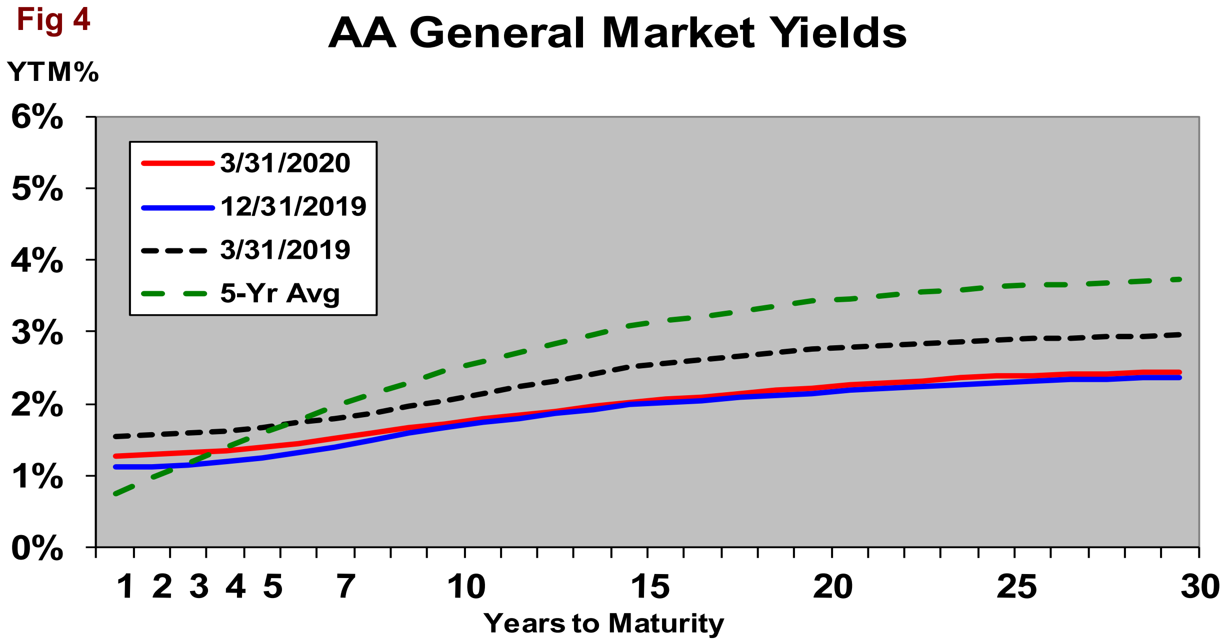
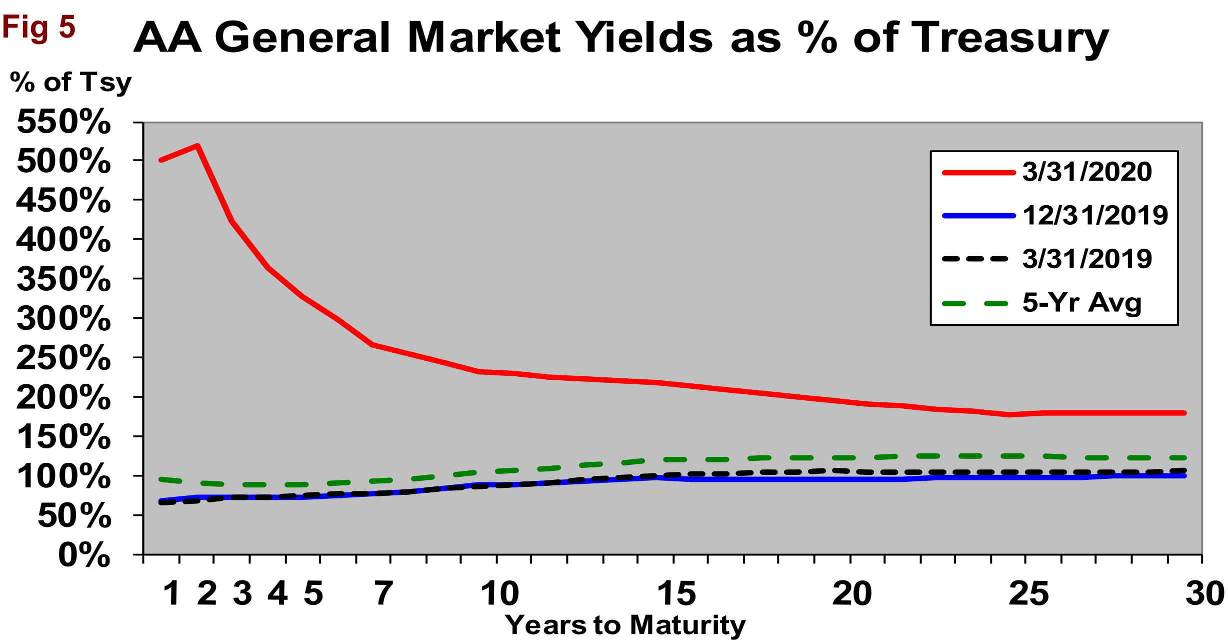


Fig 5



	5 Yr Avg	12/31/2019	3/31/2020
2-Year AA Municipal	91%	71%	520%
5-Year AA Municipal	89%	73%	327%
10-Year AA Municipal	103%	87%	231%
25-Year AA Municipal	124%	97%	178%